IDAHO OUTLOOK

NEWS OF IDAHO'S ECONOMY AND BUDGET

STATE OF IDAHO **DIVISION OF FINANCIAL MANAGEMENT** **JANUARY 2005 VOLUME XXVII NO. 7**

It appears the soaring U.S. trade deficit was finally noticed this summer. The real net exports deficit, which is the inflation-adjusted difference between U.S. exports and U.S. imports, has been growing unchecked from less than $80 billion in 1994 to nearly $600 billion a decade later. Foreigners have funded this trade imbalance. Conventional wisdom suggests this cannot last forever. At some point foreigners will balk at further financing of the trade imbalance, which will cause the U.S. dollar to depreciate against other currencies. It is estimated this occurs when the nation's current account deficit is about five percent of GDP. The deficit was at 5.75% of GDP in the third quarter of 2004 and, as anticipated, the dollar began to slide. It declined by 6% in the second half of last year.

The dollar's recent slide is the result of the huge trade imbalance. Until policies are enacted to correct this situation, there will be continued downward pressure on the U.S. dollar. It has been estimated that over 2005, the euro will top $1.40 and the dollar will buy fewer than 100 yen. However, a crash landing of the greenback seems unlikely, given America is still the major locomotive of growth and the dollar is still the principal reserve currency. On an inflation-adjusted basis, the dollar is expected to drop about 9% against the currencies of its major trading partners from 2004 to 2008.

A major positive to the weaker dollar is it makes American goods and services more competitive in the global market. This is because as the dollar falls against a currency, products valued in dollars become relatively less expensive. For example, an American made car that cost $31,595 would cost €25,000 in January 2004. At the December 2004 exchange rate, that same $31,595 car would cost €23,568. As American products become more competitive, U.S. exports should grow relative to imports. As a result, the U.S. trade deficit should eventually shrink.

Unfortunately the voyage to a more balanced trade account brings with it a major hazard of inflation. The risks of inflation arrive in two different manners. First, as the dollar falls, foreign goods and services sold in the U.S. become more expensive, and foreign companies will be pressured to raise their prices. Second, when foreign companies raise prices in the U.S., this provides an opportunity for American businesses to do the same. Despite these pressures, there are a few important reasons the falling dollar will not lead to higher inflation.

First, for most exporting nations, the U.S. market is too important to abandon. By raising prices, they risk losing their hard-won share of the U.S. market. This is something they cannot afford to do given the U.S. is the world's most lucrative market. Second, there is excess manufacturing capacity worldwide. So there is room for production to rise further before prices must increase. Third, China is a major exporter of consumer goods into the U.S., and because the Chinese peg their currency (Yuan) to the dollar, the exchange rate between the two currencies has not changed. As a result, there is no need for Chinese exporters to raise their prices.

Another hazard is the lower dollar and trade deficit put upward pressures on domestic interest rates. This is because foreign investors expect higher returns on their U.S. investments in order to be compensated for perceived risks associated with the dollar, as well as the trade imbalance. For example, a foreign investor will pay less for a U.S. government note over trade problem concerns. Because a note's price moves in the opposite direction of its yield (interest rate), the yield increases.

The trade deficit will shrink over the next few years, but not disappear. Neither is the dollar expected to collapse. The dollar should continue sliding, but not repeat its 5.7% drop from 2004 to 2005. Instead, it should decline gradually after 2005. Real exports from the U.S. should grow around 10% annually after this year thanks to the weaker dollar. In comparison, real imports into the U.S. are anticipated to grow half as fast as exports. As a result, after peaking at nearly $600 billion in 2005, the real net export deficit should drop to about $450 billion in 2008.

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General Fund Update

As of December 31, 2004

	$ Millions		
Revenue Source	FY05 Executive Estimate[3]	DFM Predicted to Date	Actual Accrued to Date
Individual Income tax	974.5	457.0	458.9
Corporate Income tax	120.6	49.5	55.6
Sales Tax	933.4	482.3	483.5
Product Taxes[1]	22.4	11.7	11.8
Miscellaneous	105.9	44.5	50.0
TOTAL GENERAL FUND[2]	**2,156.9**	**1,045.1**	**1,059.8**

1 Product Taxes include beer, wine, liquor, tobacco and cigarette taxes
2 May not total due to rounding
3 Revised Estimate as of January 2005

General Fund revenue continues to exceed expectations even as the forecast has been raised with the *January 2005 Executive Budget*. December's strength is concentrated in two revenue categories: the Corporate Income Tax ($6.1 million higher than expected) and Miscellaneous Revenue ($5.5 million higher than expected). The Sales Tax and Individual Income Tax were also a bit stronger than expected, with each contributing less than $2 million to December's gain of $14.7 million.

Individual income tax collections were $1.9 million higher than expected in December. For the month filing collections were $1.3 million higher than expected and withholding collections were exactly on target. Refunds were $0.5 million lower than expected.

Corporate income tax collections were $6.1 million higher than expected in December. Filing collections were $2.8 million lower than expected, but were offset by estimated payments that were $3.2 million higher than expected. Refunds were $3.7 million lower than expected, and miscellaneous diversions were $1.9 million lower than expected. The latter item is due to a $1.9 million transfer from the Multi-State Tax Compact Account that reflects revenue that was received in November.

Sales tax collections were $1.2 million higher than expected in December. This is the sixth straight month of stronger-than-expected sales tax collections, and this is particularly impressive in view of the almost $23 million increase in the current Sales Tax forecast versus the forecast used for the first five months of fiscal year 2005.

Product taxes were once again exactly on target in December. Miscellaneous revenue was $5.5 million higher than expected in December, primarily as a consequence of unclaimed property collections that were $4.1 million higher than expected.